Public consultation

on a draft Guideline and Recommendation of the ECB on the exercise of options and discretions available in Union law for less significant institutions

Explanatory memorandum

November 2016
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1 Context of the proposed act

1.1 Reasons for and objective of the proposal

Regulatory harmonisation in the field of prudential regulation started in 2000, when seven banking directives were replaced by a single directive. This directive was recast in 2006 as the Capital Requirements Directives (CRD I package, now repealed) to introduce the Basel II framework in the European Union (EU). It was further enhanced in 2009 (CRD II), 2010 (CRD III) and, most recently, in 2013 with Directive 2013/36/EU¹ (Capital Requirements Directive, known as CRD IV) and Regulation (EU) No 575/2013² (Capital Requirements Regulation, known as CRR) in order to, among other purposes, adopt the new Basel III standards. One purpose of the CRD IV package (i.e. CRD IV and CRR) was to further harmonise options and discretions (O&Ds) as inherited from the previous frameworks. However, the CRD IV package, as well as Commission Delegated Regulation (EU) 2015/613³ on the Liquidity Coverage Ratio (“LCR Delegated Act”) still contains a number of O&Ds. Some of these require to be applied in a general manner while others have to be applied following a case-by-case assessment of the specific situation and characteristics of individual banks.

Inconsistent application of O&Ds in participating Member States could potentially impact the overall robustness of the supervisory framework and the comparability of prudential requirements across credit institutions. This would make it difficult for market participants and the general public to gauge the overall capital adequacy and regulatory compliance of credit institutions. The high number of such provisions also adds a layer of regulatory complexity and further increases compliance costs, especially for firms operating across borders, also leaving ample room for regulatory arbitrage. Furthermore, while some of those differences will gradually diminish over the coming years as transitional arrangements are phased out, a large number of O&Ds are of a permanent nature, leaving considerable divergences in place in the absence of further steps towards harmonisation.

In line with the banking supervision mandate, applying robust prudential requirements wherever possible has been the guiding principle of the ECB’s work on O&Ds. In addition, financial integration should be enhanced through harmonised prudential requirements to ensure a level playing field across the area in which the Single Supervisory Mechanism (SSM) applies. The same prudential rules should

apply for all credit institutions showing the same risk exposure (e.g. for those with the same business model and the same level of risk). Additionally, the ECB duly considers the relevant international standards and, in particular, those emanating from the Basel Committee on Banking Supervision (BCBS) and the European Banking Authority (EBA).

The overarching goal of this initiative is to foster financial integration and to ensure the application of high supervisory standards, according to the ECB’s mandate within the framework of the SSM Regulation\(^4\) and following the objectives of the Banking Union. An appropriately harmonized treatment of O&Ds will enable the SSM to supervise banks more efficiently and from a truly single perspective. Ultimately, single European supervision can also contribute to banks being safer, sounder, and more able to support a sustainable economic recovery.

The ECB is responsible for the effective and consistent functioning of the SSM and, as part of its oversight tasks, should ensure the consistent application of high supervisory standards under the SSM. In close cooperation with the national competent authorities (NCAs), the ECB has assessed how to ensure consistency of supervisory approaches with regard to less significant credit institutions (LSIs). It has taken into account the policies for the exercise of O&Ds with respect to significant institutions (SIs) and the NCAs’ competence for the supervision of LSIs. In this light, the ECB has assessed whether identical policy recommendations should also be applied to LSIs for consistency reasons, or whether a specific approach is warranted due to differences between SIs and LSIs, for example in the business models of the latter, while also taking into account the principle of proportionality.

1.2 Context: the O&D Project

In its meeting of 24 April 2015, the Eurogroup supported a concerted work effort on O&Ds by the ECB “in order to move as rapidly as possible to a more level playing field within the Banking Union”. It was concluded that “this issue would merit being discussed further in the relevant committees (EFC/EWG)\(^5\). The ECB’s work on O&Ds was initiated during the preparatory phase of the SSM, with the relevance of this work then being confirmed by the Comprehensive Assessment. As this showed, there were very significant differences in the way O&Ds were exercised across the euro area, in particular as regards the use of the transitional CRR/CRD IV provisions for the computation of CET1 capital, measured at the reference date of 1 January 2014. These differences have a material impact on the level playing field. While some of them will gradually diminish over the coming years as transitional arrangements are phased out, a large number of O&Ds are of a permanent nature and therefore considerable differences would remain if no steps towards harmonisation were taken. All in all, the existence of differences in the way O&Ds


\(^5\) Economic and Financial Committee/Eurogroup Working Group.
are exercised significantly hampers the development of a level playing field within the Banking Union, making this issue a matter of priority for banking supervision.

The ECB, as the competent authority for significant credit institutions under the SSM, has initiated a project designed to address these issues and promote the harmonisation of the regulatory and supervisory framework. The goal of the O&D project is to assess how to exercise, in the best interests of the Banking Union, those O&Ds available under the CRD IV legislative package and granted to competent authorities.

For the purposes of supervising significant institutions the ECB has exercised the O&Ds through two separate instruments: a Regulation for O&Ds of general application and a Guide explaining the policy stance on case-by-case O&Ds. The ECB Regulation and the first version of the ECB Guide on options and discretions available in Union law were the result of the first phase of this project, which began in November 2014 and ended in March 2016. These instruments were submitted for public consultation from November to December 2015 and finalised, approved and published in March 2016. The ECB Guide (first version) became operational, as a legally non-binding instrument, from its date of publication (24 March 2016). The ECB Regulation on the exercise of options and discretions entered into force on 1 October 2016. In a second and final phase of the project the exercise of eight additional O&Ds was addressed. The draft Addendum to the ECB Guide was published for consultation in May 2016 and finalised, approved and published in August 2016.

1.3 Policy principles and processes for the extension of O&D policies to the supervision of LSIs

The formulation of a policy for O&Ds under the SSM requires developing a policy stance for O&Ds (i) with regard to SIs for which the ECB is directly competent and (ii) with regard to LSIs, as part of the ECB’s task of ensuring effective and consistent functioning of the SSM, fostering consistency of supervisory outcomes and applying high quality standards, also taking into account the principle of proportionality. Based on the ECB Regulation and the ECB Guide it has been assessed whether each O&D should be exercised in a similar manner for significant and less significant institutions to ensure a consistent application of high supervisory standards and the functioning of the system or whether a different approach is deemed to be appropriate. This assessment has been guided by the principle that the same prudential rules should apply for the same risk exposure (e.g. triggered by business model and risk level).

The exercise of O&Ds with respect to LSIs has been analysed with a particular view to the principle of proportionality, i.e. to what extent a different policy recommendation may be warranted for the exercise of specific options. As a result it is proposed, for a number of O&Ds, to maintain flexibility for the NCAs as

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harmonisation is not deemed to be necessary to ensure the robustness of supervision or to attain a level playing field.

The O&D policies for LSIs have been prepared in close cooperation with NCAs. A careful analysis of the prudential issues underlying each O&D and the relevance for LSI supervision was conducted before the policy guidance was drawn up.
2 Legal elements of the proposal

Article 4(1) of the SSM Regulation provides that the ECB has exclusive competence to carry out, for prudential supervisory purposes, the tasks defined therein with respect to all credit institutions established in the SSM participating Member States. The legislation draws a general distinction and establishes a distribution of responsibilities between SIs (under direct ECB supervision) and LSIs (directly supervised by the NCAs). This allocation of supervisory responsibilities remains without prejudice to the ECB’s role of overseeing the functioning of the system (Article 6(5)(c) of the SSM Regulation), also in conjunction with its general responsibility for the effective and consistent functioning of the SSM (Article 6(1) of the SSM Regulation).

Within this framework, NCAs are primarily responsible for exercising, vis-à-vis LSIs, O&Ds available to competent authorities in Union law. Nonetheless, the ECB’s overarching role of oversight within the SSM supports the objective of exercising O&Ds consistently both for SIs and LSIs where a harmonised approach is warranted from a prudential perspective.

The SSM Regulation refers to several different legal instruments which the ECB can adopt in order to carry out the tasks conferred on it. In particular, Article 6(5)(a) of the SSM Regulation provides that the ECB may issue regulations, guidelines or general instructions (binding legal instruments) addressed to NCAs pursuant to which the tasks defined in Article 4(1)(b), (d) to (g) and (i) of the SSM Regulation are performed and supervisory decisions are then adopted by the NCAs.

In addition, Article 4(3) of the SSM Regulation also envisages the possibility for the ECB to adopt guidelines, recommendations and decisions for the purpose of carrying out the tasks entrusted to it by the Regulation. In the light of this provision, the ECB also has the possibility to adopt recommendations – non-binding legal instruments – applicable to NCAs where deemed necessary for the prudential supervision of LSIs, having in mind, in particular, its responsibility to ensure the effective and consistent functioning of the SSM.

Two distinct instruments are submitted in this consultation. The first document, the Guideline, is a binding legal instrument. It sets out how NCAs should exercise a number of O&Ds of general application for LSIs where a specific policy rationale justifies the adoption of a uniform approach. The aim here is to ensure that prudential supervision of credit institutions is implemented in a coherent and effective manner, the single rulebook for financial services is applied in the same manner to credit institutions in all Member States participating in the SSM, and credit institutions are subject to supervision of the highest quality.

The second document, the Recommendation, is a non-legally binding instrument that provides guidance to NCAs on how to individually assess certain other O&Ds. Establishing a common set of specifications is necessary in order to promote consistent supervisory practices within the SSM and to foster where needed the
equal treatment of SIs and LSIs. It will also help achieve a level playing field for all credit institutions across the Member States participating in the SSM, while at the same time respecting NCAs’ responsibilities for the prudential supervision of LSIs. Furthermore, the Recommendation provides guidance to NCAs on how to exercise and individually assess a number of O&Ds for which a common LSI-specific approach is warranted.
3 Detailed explanation of the proposal and policy rationale

3.1 Content of the proposal

3.1.1 Structure of the proposal

Chapter I of the Guideline deals with the subject matter and scope of, and the definitions used in, the Guideline.

Chapter II provides for the exercise of general O&Ds regarding LSIs that require full alignment with the supervisory policies for SIs as laid down in Regulation (EU) 2016/445. Chapter II is structured as follows:

- Section I: Own funds (Article 89 of the CRR)
- Section II: Capital requirements (from Article 178 to Article 282 of the CRR)
- Section III: Large exposures (Article 400 of the CRR)
- Section IV: Liquidity (Article 24 of the LCR Delegated Act)
- Section V: Transitional provisions of the CRR (from Article 471 to Article 478 of the CRR)

Part 1 of the Recommendation deals with the subject matter and scope of, and the definitions used in, the Recommendation.

Part 2 provides for the exercise of O&Ds for which a specific approach for LSIs, which differs from the supervisory policies for SIs as laid down in Regulation (EU) 2016/445 and the ECB Guide on options and discretions available in Union law, is recommended. Part 2 is structured as follows:

- Part 2 II: Waivers of prudential requirements (Article 8 of the CRR)
- Part 2 III: Capital requirements (from Article 129 to Article 380 of the CRR)
- Part 2 IV: Institutional protection schemes (Article 49 of the CRR)
- Part 2 V: Liquidity (Article 420 of the CRR)
- Part 2 VI: Prudential supervision (from Article 76 to Article 115 of CRD IV)

Part 3 of the Recommendation provides for the exercise of O&Ds on a case-by-case basis for which an approach common to all credit institutions is recommended. For these O&Ds it is recommended that NCAs apply the harmonised policy approach set out in the ECB Guide on options and discretions available in Union law. A table with
the references to the relevant paragraphs of the Guide is annexed to the Recommendation.

3.1.2 Policy rationale underlying the common approach for individual O&Ds

Draft Guideline laying down the principles on the exercise of some O&Ds of general application available in Union law for LSIs

The O&Ds granted to competent authorities with reference to own funds and capital requirements under Articles 89(3), 178(1)(b) and 282(6) of the CRR, as well as the transitional provisions envisaged in Articles 471(1) and 478(3)(a) and (b) of the CRR, have an impact on the level and quality of regulatory own funds and the capital ratios of LSIs. A prudent and consistent application of these O&Ds is warranted, in order to ensure that the risks related to qualifying holdings outside the financial sector are adequately addressed and the definition of default is used in a consistent manner. The prudent and consistent application of these O&Ds is also intended to ensure that own funds requirements for transactions “with a non-linear risk profile, or for payment legs and transactions with debt instruments as underlying for which the institution cannot determine the delta or the modified duration”, are calculated in a prudent way. The harmonised application of transitional provisions related to deferred tax assets and to the deduction of equity holdings in insurance companies for institutions which are not part of a financial conglomerate will ensure that the more rigorous definition of regulatory capital introduced by the CRR is implemented by all credit institutions in the Member States participating in the SSM within an adequate time period.

The O&D regarding exemption of exposures from the application of the large exposure limits set out in Article 395(1) of Regulation (EU) No 575/2013 requires consistent application between SIs and LSIs to establish a level playing field for credit institutions in the participating Member States and to limit concentration risks arising from specific exposures. Consistent application will also ensure that the same minimum standards are applied for the assessment of compliance with the conditions specified in Article 400(3) of Regulation (EU) No 575/2013. In particular, concentration risks arising from covered bonds falling within the terms of Article 129(1), (3) and (6) of Regulation (EU) No 575/2013 and exposures to or guaranteed by regional governments or local authorities of Member States, where those claims would be assigned a 20% risk weight under Part Three, Title II, Chapter 2 of Regulation (EU) No 575/2013, should be limited. For intragroup exposures, including participations or other kinds of holdings, it needs to be ensured that the decision to fully exempt these exposures from the application of the large exposure limits is based on a thorough assessment as specified in the Annex of ECB Regulation (EU) 2016/445. For the assessment of whether an exposure, including participations and other kinds of holdings in regional or central credit institutions with which the credit institution is associated in a network, meets the conditions for an exemption from the large exposure limits, the application of common criteria is warranted. This would
ensure that significant and less significant institutions that are part of the same network are treated in a consistent way.

The O&Ds granted to competent authorities under Article 24(4) and (5) of the LCR Delegated Act with reference to the calculation of outflows from stable retail deposits covered by a deposit guarantee scheme (DGS) for the purpose of calculating liquidity coverage requirements should be exercised consistently for SIs and LSIs in order to ensure identical treatment of credit institutions belonging to the same DGS.

**Draft Recommendation on common specifications for the exercise of some O&Ds available in Union law for LSIs**

With respect to the O&Ds related to consolidated supervision and waivers of prudential requirements, the promotion of common specifications for the assessment of SIs and LSIs aims to encourage NCAs to adopt a strict approach based on the granting of such waivers on an individual basis. These decisions should be taken in a consistent manner to ensure a level playing field between credit institutions within the SSM.

As regards the O&Ds relating to own funds and capital requirements, a consistent and prudent approach is deemed to be necessary as these decisions have an impact on the amount and composition of available own funds. The same applies for AT1 and Tier 2 instruments or minority interests that may be included in own funds under certain conditions. Furthermore, a level playing field supports the consistent application of standardised approaches, the internal ratings-based approach, internal model method and internal model approach for the calculation of own fund requirements throughout the area in which the SSM applies. To ensure a level playing field between credit institutions in the SSM area, the assessment of compliance with CRR conditions to permit the application of a zero per cent risk weight for the calculation of own fund requirements for intra-group exposures should be based on a set of common specifications.

For the O&Ds that are relevant for institutions that have entered into an institutional protection scheme the use of a common set of specifications for the assessment of applications is necessary to ensure consistency, as institutional protection schemes typically consist of both significant and less significant institutions.

As regards compliance with large exposures requirements, the promotion of a common approach aims to ensure a prudent treatment of large exposures for all credit institutions within the SSM to ensure that concentration risks are adequately managed and limited.

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7 With regard to the application of Article 366(4) of the CRR on the calculation of the addend for overshootings on the basis of back-testing it should be noted that the EBA is currently drafting a Regulatory Technical Standard (RTS) on the Assessment Methodology for Market Risk Internal Models. At present, the definition of actual profit and loss (P&L) differs across those countries where the SSM applies, with corresponding impacts on the number of overshootings. According to the draft Recommendation the calculation of the addend should be based on hypothetical and actual changes in the portfolio value. Before finalising the Recommendation the question of whether the definition of actual P&L has been harmonised in the context of the EBA RTS will be considered.
With respect to the O&Ds related to liquidity a consistent and prudent approach is deemed to be necessary as these options have an impact on the LCR calculation, for example by specifying the treatment of specific in- and outflows.

Regarding the waiver for credit institutions permanently affiliated to a central body under Article 21(1) of the CRD IV, a consistent treatment of SIs and LSIs should be applied to attain a level playing field.

For O&Ds related to governance arrangements and prudential supervision a prudent and consistent approach is deemed to be necessary to ensure that credit institutions are subject to adequate governance requirements. This Recommendation also covers O&Ds relating to cooperation between competent authorities. Smooth cooperation within the SSM and with competent authorities in non-participating Member States needs to be ensured.

3.1.3 Policy rationale underlying LSI-specific policies for individual O&Ds

In the majority of cases, the policy proposals for LSIs included in the draft ECB Guideline and the draft ECB Recommendation that are now being published for consultation are the same as those adopted for SIs. Nevertheless, for a number of O&Ds the intention is to apply a common approach for LSI supervision that deviates from the policy stance developed for SIs. In other cases, NCAs will be able to take a flexible approach to the application of some O&Ds.

**Liquidity waivers at cross-border level (Article 8(3) of the CRR):** With respect to the granting of liquidity waivers, the promotion of common specifications for the assessment of SIs and LSIs aims to encourage NCAs to adopt a strict approach in the granting of such waivers on an individual basis. Furthermore, the application of a common approach on how to assess individual applications will support any decisions on these waivers that have to be taken in the context of supervisory colleges. The specifications for Article 8(1)(3)(b) of the CRR in the ECB Guide are only applicable to sub-entities or groups of sub-entities in one Member State that fulfil the significance designation according to the SSM Framework Regulation. Therefore these specifications are not applicable to LSIs.

**Entities excluded from the scope of prudential consolidation (Article 19(2) of the CRR):** For significant institutions the ECB is of the view that the exclusion of undertakings from consolidation in the context of this Article should only be allowed in cases permitted by the CRR and that are consistent with the Basel Committee standards. For proportionality reasons the execution of this option is left to the discretion of the NCA, bearing in mind that the majority of LSIs do not fall under the Basel framework.

**Deduction of holdings in the presence of institutional protection schemes (Article 49(3) of the CRR):** Significant and less significant institutions may belong to the same institutional protection scheme. Therefore, and in order to ensure the consistent application of this provision within the SSM, any decision to grant the permission referred to in Article 49(3) of the CRR should be based on the same
criteria. In view of the large number of members of some of the existing institutional protection schemes the administrative burden needs to be reduced as far as possible. The NCA should be able to allow an IPS to submit an application to apply Article 49(3) of the CRR on behalf of all LSIs that are members of the scheme. The NCA should also be able to take one single decision to grant permission according to Article 49(3) of the CRR to all LSIs that are covered by the application.

**Exposures in the form of covered bonds (Article 129(1) of the CRR):** Applying this O&D differently to SIs and LSIs would imply that for the preferential treatment of exposures to covered bonds in the CRR different quality criteria regarding covered bonds would apply for SIs and LSIs. A harmonised transposition and application of this option is necessary to ensure that specific covered bonds are treated consistently within the SSM. Therefore NCAs should coordinate the potential use of this option with the ECB.

**Treatment of exposures to central counterparties (Article 311(2) of the CRR):** It is recommended that LSIs should be allowed to apply the treatment set out in Article 310 of the CRR to their trade exposures and default fund contributions to a central counterparty (CCP) in the event that the CCP has ceased to meet the conditions provided for in Article 311(2) of the CRR. In order to promote consistency within the SSM, the assessment of why the CCP has stopped calculating \( K_{\text{CCP}} \) (hypothetical capital) should be done centrally by the ECB and it is recommended that NCAs follow the ECB assessment.

**Waiver in the event of system failure (Article 380 of the CRR):** Article 380 of the CRR deals with the case of a system-wide failure of a settlement system, a clearing system or a CCP. For SIs, the ECB will confirm such an event by issuing a public statement. Until the ECB issues a further public statement to the effect that the situation has been rectified, credit institutions will not be required to comply with the own funds requirements laid down in Articles 378 and 379 of the CRR. Moreover, the failure of the counterparty to settle a trade will not be deemed a default for credit risk purposes. With regard to LSIs the ECB is of the view that NCAs should have the discretion to decide if they want to make use of this O&D. However, some coordination between the ECB and NCAs is considered to be necessary. If the ECB confirms the occurrence of a system-wide failure within the meaning of Article 380 of the CRR by issuing a public statement it is recommended that NCAs publish a confirmation in parallel.

**Limits to large exposures (Article 395(1) of the CRR):** For significant institutions the ECB has determined that the limit on the value of large exposures within the meaning of Article 395(1) of the CRR must not be lower than €150 million. This option is only relevant for small institutions with eligible capital below €600 million. For LSIs it should be at the discretion of the NCA to set a lower large exposure limit if deemed necessary.

**Compliance with liquidity requirements (Article 414 of the CRR and Article 4(4) of the LCR Delegated Act):** A breach of the LCR, which means a lack of short term liquidity, is considered a severe situation. Nonetheless, applying the policy developed for significant institutions also to LSI supervision is not deemed to be
necessary. Based on the assessment of each specific situation NCAs should assess whether a lower reporting frequency (than daily) and a longer reporting delay (later than by the end of each business day) could be authorised, in line with the conditions stipulated in Article 414 of the CRR.

**Reporting obligations (Article 415(3) of the CRR):** This provision refers to tools for the purpose of monitoring compliance with existing national liquidity standards. With respect to LSIs it should be left to the discretion of the NCA to decide which tools to use to monitor national liquidity standards.

**Liquidity outflows (Article 420(2) of the CRR):** For consistency reasons an outflow rate of 5% should be applied for trade finance off-balance sheet-related products by all credit institutions in the SSM. However, if NCAs have calibrated the applicable outflow rates based on statistical evidence in the LSI sector an outflow rate below 5% may be applied for trade finance off-balance-sheet related products.

**Intragroup liquidity inflows and outflows (Articles 422(9) and 425(5) of the CRR and Article 29(1) and (2) and Article 34(1), (2) and (3) of the LCR Delegated Act):** On 27 July 2016 the EBA published the final draft Regulatory Technical Standards on the specification of the additional objective criteria referred to in Articles 29(2) and 34(2) of the LCR Delegated Act. After their adoption by the European Commission these Regulatory Technical Standards will be directly applicable. It is not deemed necessary to further specify the application of these provisions for the purposes of LSI supervision.

**Combining the risk committee and the audit committee (Article 76(3) of CRD IV):** This provision is applicable for all credit institutions that are not considered to be "CRD IV significant", i.e. significant based on their size, internal organisation and the nature, scope and complexity of their activities. To take account of the principle of proportionality it is recommended to exercise this option for LSIs that are considered as not significant based on the CRD IV criteria and to allow these institutions to combine the risk committee with the audit committee.

**Bilateral agreement on the supervision of credit institutions in non-participating Member States (Article 115(2) of CRD IV):** According to Article 4(1)(a) and (c) of the SSM Regulation, the ECB is exclusively competent within the SSM to authorise, and to withdraw authorisation of, credit institutions. Since this option is available for the competent authority responsible for authorisations, cooperation between the NCA and the ECB is needed before the NCA may (a) delegate direct supervision of an institution which is an LSI to the competent authority responsible for the supervision of the parent undertaking or (b) assume responsibility for directly supervising a subsidiary of a parent undertaking which is an LSI.

Several O&Ds in the CRR are related to transitional arrangements. For the transitional arrangements that expire at the end of 2017 no policy proposals for LSI supervision are envisaged as differences in these requirements will automatically cease to exist at that time.
3.2 O&Ds requiring follow-up actions

The ECB Guide includes O&D provisions where further action or assessment is required. Specific policy guidance, potentially including more detailed specifications, will be communicated on the basis of future regulatory developments or further assessment, and, where appropriate, also in cooperation with NCAs.

If more specific policies and specifications for these O&Ds are developed in the future for the supervision of SIs, the ECB will assess, in close cooperation with NCAs, to which extent these policies and specifications should be extended to the supervision of LSIs.